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ABSTRACT

Designed for the general public and possibly suitable also for high school economics students, this pamphlet discusses a federal law that requires that the borrower as well as the lender comply with government rules relating to the use of credit in purchasing securities, even when the borrower obtains credit outside the United States. The pamphlet focuses on Regulation X, entitled "Rules Governing Borrowers Who Obtain Securities Credit," as one of four margin regulations relating to securities credit. A brief explanation of margin regulations and a description of how margin works is followed by an historical look at the essential role government regulation of securities credit plays in preventing national money crises. Concern over the potentially upsetting effects that borrowing abroad to buy U.S. stocks might have on securities markets in the United States is described as the main reason for the implementation of the law. Also discussed are the widespread effects of this law aimed particularly at foreign borrowing, and the penalties mandated for violators. The final section lists the cities in which Federal Reserve Banks can be contacted for further information. (LH)

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If You Borrow To Buy Stock—

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Planning to buy some stock on credit?

Whatever your objective–speculation or a long-term investment–if you need credit to close the deal, there is something you should know about.

There's a Federal law–passed by Congress effective November 1, 1971–that requires the borrower, as well as the lender, to comply with the Government's rules relating to the use of credit in purchasing securities, even when the borrower obtains the credit outside the United States.

Before that date, the responsibility of complying with these rules generally was on the lender–a bank, broker-dealer, or other type of lending institution. Now the responsibility for compliance is shared by the lender *and* the borrower. Borrowers who willfully obtain credit on securities illegally are subject to severe penalties. The maximum penalty upon conviction is a $10,000 fine and 5 years in jail.

Regulation X

The rules that borrowers must follow are described in Regulation X, issued by the Board of Governors of the Federal Reserve System. This regulation is entitled "Rules Governing Borrowers Who Obtain Securities Credit" and free copies are available at Federal Reserve offices throughout the country and most U.S. embassies abroad. Banks, broker-dealers and many other lenders also have copies of the Regulation or are familiar with its provisions. Ask your banker or broker about them.

Margin Regulations—What Are They?

Since the early 1930's, the Federal Reserve has been directed by law to restrain the excessive use of credit for the purpose of buying securities. This is done by setting a limit on the amount of funds that banks, broker-dealers and others may lend on stock and convertible bonds. The limit is always less than the market value of the securities that are pledged as collateral. The difference between the credit value and the market value is known as the customer's margin.

Regulation X is one of four regulations issued by the Federal Reserve relating to securities credit. The other three apply to the various types of *lending* institutions. Regulation T, for example, sets forth the rules that *broker-dealer firms* must follow in extending credit on securities. Regulation U applies to *bank* credit for the purpose of purchasing or carrying margin stocks, while Regulation G applies to *all other types of lenders* who extend securities credit.

How Margin Works

When the Federal Reserve sets a margin requirement it is, in effect, specifying the minimum down payment that must be made in a transaction. For example, if the margin requirement is 55 per cent, a borrower subject to Regulation X would be required to make a down payment equal to at least 55 per cent of the total dollar amount of the transaction. He could obtain credit for the remaining 45 per cent.* If the Federal Reserve Board decided that an excessive amount of credit were being extended at this margin level, it could increase the required down payment for *new* credit. Conversely, if the Board decided that sound transactions were being unnecessarily restrained at this margin level, it could lower the required down payment.

Why Government Regulation?

The idea that Government regulation of securities credit might play an essential role in preventing money crises goes back more than 60 years. In 1910, a study by the National Monetary Commission showed that extensive use of stock

* If he does not have the cash, he could satisfy the margin requirements by depositing stock collateral with a sufficient loan value. For example, he could borrow $1,000 by depositing stock having a market value of $2,222 (45 per cent of $2,222 equals about $1,000).

market credit accompanied major financial crises from 1873 to 1907. Direct controls on the use of securities credit were not imposed, however, until 1933.

In that year, Congress directed the Federal Reserve to restrain the undue use of *bank* credit for speculation in securities. The following year—in the Securities Exchange Act of 1934—the Federal Reserve was specifically authorized to issue regulations setting limits on the amount of credit that *broker-dealers, banks,* and any *other lenders* may provide for the purpose of purchasing or carrying securities. Until 1969, these regulations applied only to securities listed on national stock exchanges such as the New York and American exchanges. In that year, the law was expanded to include securities sold outside the exchanges—in the so-called "Over-the-Counter" market. Over 1200 of these OTC securities—with characteristics similar to those listed on the exchanges— are now subject to margin regulation. The Federal Reserve periodically publishes a list of OTC margin stocks for the information of the public.

The borrower became subject to margin regulations through Title III of the Public Law 91-508, effective November 1, 1971. The Federal Reserve issued Regulation X to implement that law.

The Congressional committees that prepared the 1970 law expressed concern about the potentially upsetting effect that borrowing abroad to buy U.S. stocks might have on securities markets in the United States. Consequently, the law is aimed particularly at foreign borrowing. However, its provisions apply as well to borrowing in this country.

New Law Affects Many Investors

Many investors are affected by the law and Regulation X. More than 30 million Americans own stocks and bonds and margin credit totaling several billions of dollars is outstanding at any given time.

Regulation X requires a borrower to comply with the Federal regulation that applies to the person or firm extending him credit to buy a security. If the credit is obtained from a broker-dealer, for example, then the borrower—as well as the broker-dealer—must comply with the Regulation T. If a person borrows abroad, he must comply with the margin regulation that would apply if the credit were obtained in the United States—even if the foreign lender is not subject to any margin regulation.

Violations

A borrower is subject to prosecution if a violation of the law or regulation is willful. Any person who willfully aids or abets the violation of any provision of Regulation X is considered to be a violator and could be prosecuted.

Remember! The penalties for violations are severe in many cases. Upon conviction they range as high as a $10,00 fine and 5 years in jail.

Get The Facts

Get the facts and familiarize yourself with the margin regulations *before* you obtain credit to buy securities.

Further information may be obtained from the Board of Governors of the Federal Reserve System in Washington or from any Federal Reserve Bank or office. Federal Reserve Banks are located at Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas and San Francisco. Other offices are located at Buffalo, Cincinnati, Pittsburgh, Baltimore, Charlotte, Birmingham, Jacksonville, Miami, Nashville, New Orleans, Detroit, Little Rock, Louisville, Memphis, Helena, Denver, Oklahoma City, Omaha, El Paso, Houston, San Antonio, Los Angeles, Portland, Salt Lake City and Seattle.

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